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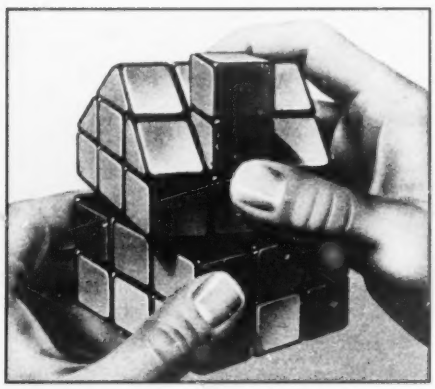
1991 Dodge/Sweet's Construction Outlook

First Update
April 1991



1991: The Turnaround Year

Last October's *Outlook* for construction contracting in 1991 concerned the second stage of a fairly typical two-year cyclical decline of building activity. In year one—1990—the construction industry was knocked off its pedestal as the value of newly started projects plummeted 11 percent. That much was already history when the 1991 *Outlook* was first issued.

In year two—that's 1991—a secondary setback was anticipated, and still is. Unlike 1990's "free fall" when market conditions worsened with each successive quarter, 1991's smaller decline will be cushioned by a mid-year turnaround of the Dodge Index of construction contract value.

Are We There Yet?

The opening months of 1991 brought an indication that this year is going to be different. The first requirement for turnaround is to bring the decline to a halt, and some encouragement can be taken from the recent stabilization of construction contracting. The Dodge Index, once as high as 187 (in September, 1989) fell all the way to 133 by last December, but managed to hold that level through January and February. For two very good reasons, however—one a general business recession and the other a credit crunch—a sustainable rebound of construction contracting isn't likely in the immediate future.

Assuming that this year's second quarter will bring the conclusion of the 1990/91 decline of construction contracting, one issue that can be put to rest is: How does this current cyclical reversal compare with previous ones?

Before matching the 1990/91 downturn against its two predecessors, it is necessary to make the usual adjustments for inflation. That being done, and if 1991:II turns out to be the bottom of the current cycle, comparison with previous declines shows this one to be close to the average duration, but not as deep (from peak to trough -25 percent vs. an average of -40 percent). Some special features of the last (early 1980's) decline which are *not* evident in the current situation help to explain the greater severity of the previous crash.

• The early 1980's decline of construction contracting occurred in the context of a considerably more formidable general recession than the 1990/1991 "mild" setback.

• The previous construction decline was intensified by highly restrictive monetary policy which had the effect of trading double digit interest rates for double digit inflation. This time around, the Federal Reserve has been pushing interest rates down.

•The earlier construction recession, like that of the economy at large, was a "double dip" event. A short-lived recovery which began in 1980 soon aborted, and contracting sank back to an even lower trough in 1982:II. The entire two-part recession of the early 1980's spanned a total of 15 quarters before sustained recovery took hold in 1983.

The current construction recession has a few special features of its own which are worth bearing in mind.

• All of the decline has been confined to *privately* financed construction (housing and commercial/industrial building). Publicly funded work (infrastructure and institutional building) came through 1990 and 1991 unscathed, and served as a market stabilizer through the downturn.

• The 1990/91 recession was something of a bi-coastal phenomenon. Led by the collapse of building in the Northeast, the two eastern regions and the western region took two-year declines of 22 percent and 13 percent respectively. By contrast, the central regions collectively lost only 6 percent of their 1989 construction market through 1991.

THREE BUILDING RECESSIONS COMPARED

Period of Decline	Duration In Quarters	Percent Decline From Peak to Trough
1973:I to 1975:I	8	-41%
1978:III to 1980:II (1978:III to 1982:II)*	7 (15)*	-38% (-40%)*
1989:III to 1991:II	7 est.	-25% est.

**Includes renewed decline following aborted recovery*

The View From The Valley

In the customary 25 words or less, the status of the construction market in the early Spring of 1991 (as measured by the Dodge Index) goes something like this: the decline of contracting for new construction has probably bottomed out, but recovery is still a few months away. Beyond the immediate issue of a turnaround is the question of how strong the recovery will be when it gets here. That's a subject to be considered in October's *1992 Outlook*. The main business for 1991 is getting out of the valley.

Successful conclusion of the Gulf War removes one variable from the outlook equation and helps to clarify another. The restoration of what passes for peace in the Middle East lends credibility to the widely-accepted expectation of an early recovery from the general recession of 1990/91. With the energy component of the CPI dormant for the time being, a period of acceptable inflation leaves the Federal Reserve in a position to provide the monetary stimulus needed to guide the economy out of its slump.

As a leading indicator of general economic activity, construction contracting should be on its way up *before* the less sensitive GNP data confirm that the economy has snapped out of its recent recession. And if, as it is generally believed, the economy's upturn is due in the third (or fourth) quarter, construction's bellwether homebuilding industry would ordinarily get there first. There is, however, one other important condition to be met, and that is an easing of the credit crunch of 1990. It does little good for the Fed to push interest rates down as long as lenders continue to boycott real estate development.

Getting Past The Crunch

What began in 1989 as a Savings and Loan crisis turned into a general credit crunch in 1990 when commercial banks were subjected to controls similar to those applied earlier to the S&Ls (as mandated by FIRREA). The regulatory clampdown on commercial banks, unlike the reform of the scandal-ridden thrifts, was largely precautionary (and perhaps even an over-reaction) but the result was similar. The requirement that commercial banks restructure their real estate portfolios, set up reserves against "non-performing" loans, write down overvalued real estate holdings, and improve their capital-to-loan ratios brought heavy loses in 1990's final quarter. It also led to the virtual paralysis of real estate finance.

1991 National Estimates
Dodge Construction Potentials

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		1990 Actual	1991 Forecast	Percent Change 1991/90
Nonresidential Buildings				
Floor Area (millions of square feet)	Office Buildings	157	125	-20
	Stores & Other Commercial	479	380	-21
	Manufacturing Buildings	120	115	-4
	Total Commercial & Manufacturing	756	620	-18
	Educational	142	138	-3
	Hospital & Health	68	66	-3
	Other Nonresidential Buildings	149	146	-2
	Total Institutional & Other	359	350	-3
	Total Nonresidential Buildings	1,115	970	-13
Contract Value (millions of dollars)	Office Buildings	$ 16,748	$ 14,400	-14
	Stores & Other Commercial	22,979	19,150	-17
	Manufacturing Buildings	7,326	7,275	-1
	Total Commercial & Manufacturing	$ 47,053	$ 40,825	-13
	Educational	$ 15,414	$ 15,500	+1
	Hospital & Health	8,937	8,950	--
	Other Nonresidential Buildings	15,573	15,550	--
	Total Institutional & Other	$ 39,924	$ 40,000	--
	Total Nonresidential Buildings	$ 86,977	$ 80,825	-7
Residential Buildings				
Dwelling Units (thousands of units)	One Family Houses	841	815	-3
	Multifamily Housing	292	235	-20
	Total Housekeeping Residential	1,133	1,050	-7
Floor Area (millions of square feet)	One Family Houses	1,500	1,460	-3
	Multifamily Housing	315	253	-20
	Nonhousekeeping Residential	51	42	-18
	Total Residential Buildings	1,866	1,755	-6
Contract Value (millions of dollars)	One Family Houses	$ 84,033	$ 83,675	--
	Multifamily Housing	16,779	14,200	-15
	Nonhousekeeping Residential	4,597	4,075	-11
	Total Residential Buildings	$105,409	$101,950	-3
Nonbuilding Construction				
Contract Value (millions of dollars)	Transportation Construction	$ 24,558	$ 26,325	+7
	Environmental Construction	20,280	18,475	-9
	Total Public Works	$ 44,838	$ 44,800	--
	Utilities	$ 4,337	$ 4,300	-1
	Total Nonbuilding Construction	$ 49,175	$ 49,100	--
All Construction				
Contract Value (millions of dollars)	**Total Construction**	$241,561	$231,875	-4
	Dodge Index (1982=100)	154	148	

*F.W. Dodge basis

There is no quick fix for the credit crunch of 1990/91. Perhaps the best that can be said is that 1990 was the time of maximum regulatory stress for the banking system. But even as the crunch eases, its consequences for the building business are all too obvious. Unlike the early and middle 1980s, when lenders were recklessly eager to back real estate deals with few questions asked, they will be erring on the side of conservatism and selectivity.

Watch These In 1991

Two major categories of construction will be especially handicapped by the 1991 environment of scarce credit and a weak economy. One of them is housing;

1991 Regional Estimates
Dodge Construction Potentials

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Northeast

CT, ME ,MA, NH, NJ, NY, PA, RI, VT

Contract Value (millions of dollars)

	1990 Actual	1991 Forecast	Percent Change 1991/90
Nonresidential Building			
Commercial and Manufacturing	$ 8,343	$ 7,350	-12
Institutional and Other	8,729	8,225	-6
Total	$17,072	$15,575	-9
Nonbuilding Construction	$ 9,663	$10,075	+4

	1990 Actual	1991 Forecast	Percent Change 1991/90
Residential Building			
One Family Houses	$ 9,924	$ 9,925	--
Multifamily and Nhskpg.	3,622	3,300	-9
Total	$13,546	$13,225	-2
Total Construction	$40,281	$38,875	-3

North Central

IL, IN, IA, KS, MI, MN, MO, NE, ND, CH, SD, WI

Contract Value (millions of dollars)

	1990 Actual	1991 Forecast	Percent Change 1991/90
Nonresidential Building			
Commercial and Manufacturing	$11,543	$10,200	-12
Institutional and Other	9,253	8,925	-4
Total	$20,796	$19,125	-8
Nonbuilding Construction	$10,804	$10,925	+1

	1990 Actual	1991 Forecast	Percent Change 1991/90
Residential Building			
One Family Houses	$17,764	$17,875	+1
Multifamily and Nhskpg.	4,464	3,725	-17
Total	$22,228	$21,600	-3
Total Construction	$53,828	$51,650	-4

South Atlantic

DE, DC, FL, GA, MD, NC, SC, VA, WV

Contract Value (millions of dollars)

	1990 Actual	1991 Forecast	Percent Change 1991/90
Nonresidential Building			
Commercial and Manufacturing	$ 8,968	$ 7,525	-16
Institutional and Other	7,501	7,675	+2
Total	$16,469	$15,200	-8
Nonbuilding Construction	$ 8,504	$ 8,250	-3

	1990 Actual	1991 Forecast	Percent Change 1991/90
Residential Building			
One Family Houses	$20,216	$19,425	-4
Multifamily and Nhskpg.	4,616	3,825	-17
Total	$24,832	$23,250	-6
Total Construction	$49,805	$46,700	-6

South Central

AL, AR, KY, LA, MS, OK, TN, TX

Contract Value (millions of dollars)

	1990 Actual	1991 Forecast	Percent Change 1991/90
Nonresidential Building			
Commercial and Manufacturing	$ 5,625	$ 5,375	-4
Institutional and Other	5,187	5,825	+12
Total	$10,812	$11,200	+4
Nonbuilding Construction	$ 8,370	$ 8,350	--

	1990 Actual	1991 Forecast	Percent Change 1991/90
Residential Building			
One Family Houses	$10,926	$12,575	+15
Multifamily and Nhskpg.	1,324	1,325	--
Total	$12,250	$13,900	+13
Total Construction	$31,432	$33,450	+6

West

AK, AZ, CA, CO, HI, ID, MT, NV, NM, OR, UT, WA, WY

Contract Value (millions of dollars)

	1990 Actual	1991 Forecast	Percent Change 1991/90
Nonresidential Building			
Commercial and Manufacturing	$12,574	$10,375	-17
Institutional and Other	9,254	9,350	+1
Total	$21,828	$19,725	-10
Nonbuilding Construction	$11,834	$11,500	-3

	1990 Actual	1991 Forecast	Percent Change 1991/90
Residential Building			
One Family Houses	$25,202	$23,875	-5
Multifamily and Nhskpg.	7,351	6,100	-17
Total	$32,553	$29,975	-8
Total Construction	$66,215	$61,200	-8

the other, retail building.

As the year opened, both single family and multifamily housing markets were in a deeply depressed state, although not for the same reasons. A general reluctance of lenders to back residential building of any kind is, of course, impacting both housing markets at present. Unfortunately, the eventual improvement of credit availability will be of little benefit to the troubled apartment/condo market where building has been declining steadily for the past five years under good credit conditions and bad. Until the oversupply created during the mid-1980s "tax shelter" boom is significantly reduced—and progress to date has been painfully slow—new starts will not exceed 300,000 units per year. Potential, once the multifamily vacancy rate returns to its traditional 5 percent, is in the vicinity of 500,000 units.

In contrast to the distorted apartment/condo market, one-family homebuilding is fundamentally sound. Until it was temporarily shut down by 1990's credit crunch, one-family housing

demand averaged a steady one million units per year from 1983 through 1989—proof of the solid demographic foundation this market enjoys.

In 1991, single family building will be responding to market conditions in two ways: negatively in the first half when recession and credit scarcity dominate, and positively in the second half as credit eases and the economy resumes an upward path. Although the second half rate of starts, at 875,000 units, could exceed the first half's weak 750,000 rate by as much as 15 percent, the change will not be quite enough to prevent another small decline of homebuilding for the full year. *More important than that, the second half rebound of homebuilding will be the beginning of the next general building cycle.*

None of the several categories of commercial and industrial building can be expected to survive 1991's recessionary environment without some further weakening, but one stands out as a bit more vulnerable than the rest. Retail building, with its familiar behavioral trait of tracking single family housing development by roughly one year, is in double trouble. The abrupt collapse of homebuilding in 1990's credit squeeze is having its delayed effect on contracting for stores and shopping centers in 1991, intensifying the recession's downward pull. The continuing decline of homebuilding through the first half of 1991 is only making matters worse.

Paced by the retreat of retail building, the decline of *total* commercial and industrial building contract value this year now falls in the range of -10 percent to -15 percent.

Again, as in 1990, publicly funded construction is buffering the continuing weakness of privately financed building. Two categories deserve honorable mention for their unwavering support.

A gain in highway/bridge contracting in 1991 comes as something of an anomaly. With the Department of Transportation temporarily between five-year programs (STAA has expired, and its replacement won't become effective until 1992), and with the deficit still out of control, it would be reasonable to expect a fairly tight lid on Federal spending for highways and other public works. That seemed to be the intent of Congress and the Administration at last fall's "budget summit" when the proceeds of a proposed new 10 cents per gallon fuel tax were to be kept in general revenue (not diverted to the Highway Trust Fund) to relieve pressure on the deficit.

That was October. By December 1, when the new tax went into effect, it had shrunk to 5 cents, but more interestingly, only 2 1/2 cents is going to general revenue. The other 2 1/2 cents goes the way of most fuel taxes—to the Highway Trust Fund. The curious result: at a time of maximum budgetary stress, DOT is enjoying a windfall, and highway/bridge contracting is up significantly. Call this "unintentional anti-recessionary fiscal policy" ... or "business as usual."

Although highway/bridge construction is alive and well in 1991, the same can't be said for the other major public works category, sewer and waste treatment facilities. One big difference: their increasing reliance on the newly created SRF's (State Revolving Funds) which have yet to realize their potential as a substitute for EPA construction grants.

With 1991 contracting for transportation construction on the rise, but environmental work slipping, total public works contract value is headed toward $45 billion, exactly where it was in 1990 and 1989—and just incidentally, the biggest number on record.

Like public works construction, institutional building (schools, healthcare facilities, public administration buildings, etc.) is capable of matching 1990's record contract value in 1991, but isn't likely to exceed it. A full decade of uninterrupted expansion has managed to keep pace with the supportive demographics of this building market which responds to what is going on at the end of the population spectrum (0 to 15 and over) where growth is exceeded only by the now middle-aged 50's generation.

Most institutional building is state-sponsored, and with recession currently pinching state budgets (40 are showing deficits this year), a temporary deferral of some less urgent building seems inevitable. Once the economy recovers, however, tax revenues will increase and unemployment benefits will shrink. As this happens, the growth trend of institutional building that led to a doubling of annual contract value over the past decade is bound to re-emerge. In 1991, meanwhile, institutional building is one of the few remaining pockets of support in a generally depressed construction market.

Stability of institutional building and strength in highway construction will partially offset the continuing decline of housing and commercial building this year, but that's as much as they are capable of doing. Total construction contract value, now forecast at $231.9 billion, will slip another 4 percent in 1991 as the conditions which triggered last year's 11 percent decline gradually relent.

Regional differences in 1991 are not expected to be as pronounced as they were in 1990 when the nation's coastal areas bore the brunt of the downturn.

- The **Northeast**, which led the nation into decline, virtually collapsed in 1990 when contracting fell 20 percent. Risk of further setback from the currently depressed level of building is small.
- The **South Atlantic** and the **West,** whose cyclical downturns occurred later than that of the Northeast, are still adjusting to changed market conditions and will be the regions with above-average declines in 1991.
- The **North Central,** which was a late participant in the 1980s building boom, is consequently least over-extended. This region will be showing only a small decline in 1991, as it did last year.
- The **South Central** has been going the wrong way for the past half-dozen years, but finally offers an opportunity for modest improvement. This region is a "special case" in which local market conditions outweigh general economic and financial considerations.

Leaving The Eighties Behind

The collapse of the 1980s building boom in 1990/91 might be thought of as a delayed reaction to a combination of extraordinary events. Abuses of the opportunity for accelerated depreciation of commercial buildings, coincident with the deregulation of the thrift industry (and its eventual self-destruction), explain a lot of what went wrong in the "Avaricious Eighties." The coming recovery of the construction sector will follow a more traditional pattern even as it is conditioned by a few unique circumstances of the "Back-to-Normal Nineties." More about that later.

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